No. 15399

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

EDWARD POOL and LOTTIE POOL, EDWARD POOL, LOTTIE POOL, WILLIAM K. MURPHY, EDNA MURPHY, WILLIAM K. MURPHY and EDNA MURPHY,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petitions for Review of the Decisions of the Tax Court of the United States.

BRIEF FOR THE PETITIONERS.

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TOPICAL INDEX

PAGE

TABLE OF AUTHORITIES CITED

ORDERS

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Opinion Below.

The only previous opinion in this case is the memorandum opinion of The Tax Court of the United States, which is unreported. [R. 29-88.]

Jurisdiction.

These Petitions for Review [R. 95-97] involve federal income taxes for the calendar years 1946, 1947, and 1948. [R. 89-94.] On May 17, 1951, the Commissioner of Internal Revenue mailed to the taxpayers a determination of deficiencies in income tax for each of the six cases

here consolidated.[1] Representative of these notices of deficiencies is the one mailed to Edward and Lottie Pool for the year 1948. [R. 8-9.] Within 90 days thereafter and on August 8, 1951, each of the taxpayers filed a petition with The Tax Court of the United States for redetermination of the asserted deficiencies under the provisions of Section 272 of the Internal Revenue Code of 1939. [R. 5-8.] The decisions of The Tax Court of the United States sustaining the deficiencies in part were entered August 21, 1956. [R. 89-94.] These cases were brought to this Court by Petitions for Review filed November 5, 1956 [R. 95-97] pursuant to the provisions of Section 7482 and Section 7483 of the Internal Revenue Code of 1954.

Question Presented.

The taxpayers sold duplexes during the taxable years. These buildings had been leased to tenants from the time acquired by taxpayers until they were sold. The question is whether under the circumstances of this case the duplexes which concededly were "real property used in the trade or business" of the taxpayers are nevertheless to be

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[1]An order of this Court filed January 10, 1957 [R. 533-535] consolidated the six cases for purposes of "briefing, hearing and decision under the title of Edward Pool and Lottie Pool, *et al.*, v. Commissioner of Internal Revenue." That order also provided that the documents included in the transcripts of record on review in the five cases bearing Tax Court Nos. 36109-36113 inclusive not be printed, but that only the full and complete transcript in the case of Edward and Lottie Pool, Docket No. 36108, be printed, omitting, however, exhibits. The order provided, however, that the exhibits may be considered in the decision of the case as fully as if they had been printed. [R. 534.]

denied the capital gain treatment under Section 117(j) of the Internal Revenue Code of 1939, because as The Tax Court found the property was also held by the taxpayers "primarily for sale to customers in the ordinary course of . . . [their] trade or business" within the meaning of Section 117(j).

Statute Involved.

Internal Revenue Code of 1939:

> "Section 117(j) [as added by Section 151(b) of the Revenue Act of 1942, c. 619, 56 Stat. 798, and amended by Section 127(b) of the Revenue Act of 1943, c. 63, 58 Stat. 21] Gains and Losses from Involuntary Conversion and from the Sale or Exchange of Certain Property Used in the Trade or Business.
>
> "(1) Definition of property used in the trade or business. For the purposes of this subsection, the term 'property used in the trade or business' means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. . . .
>
> "(2) General Rule. If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in

part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. . . ." (26 U. S. C. (1946 Ed.), Sec. 117.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

"Section 117(j) provides that the recognized gains and losses

"(a) from the sale, exchange, or involuntary conversion of property used in the trade or business of the taxpayer at the time of the sale, exchange, or involuntary conversion, held for more than six months, which is

"(1) of a character subject to the allowance for depreciation provided in section 23(1), or

"(2) real property,

provided that such property is not of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or is not held by the taxpayer primarily for sale to customers in the ordinary course of trade of business, . . . shall be treated as gains and losses from the sale or exchange of capital assets held for more than six months if the aggregate of such gains exceeds the aggregate of such losses. . . ."

Statement.

The findings of fact and opinion of The Tax Court dealt with additional issues from which no appeals were taken. Accordingly, a considerable portion of The Tax Court's findings are no longer relevant to any issue remaining in the case. As for those findings of The Tax Court which relate to the question on appeal we have no quarrel with the exception of the conclusion that the duplexes were held for sale to customers in the ordinary course of taxpayers' business. This we show in the argument is actually a conclusion of law but in any event "clearly erroneous." Nevertheless the primary findings as a whole are in part misleading in that they detail many facts which have little relevance and omit many facts that are both relevant and material. Accordingly, we deem it appropriate to present properly the facts to this Court to summarize the Tax Court's findings of fact [R. 33-70], but supplement those findings with material facts which have been omitted where required by either the stipulation of facts [R. 17-29], or uncontradicted and unimpeached testimony which without exception is supported by either documentary evidence or cumulative testimony of disinterested witnesses. These facts may be summarized as follows:

1. Edward Pool and Lottie Pool are husband and wife, as are William K. Murphy and Edna Murphy. Each couple filed its federal income tax returns on the cash basis and by calendar years with the Collector of Internal Revenue for the Sixth District of California. For the years 1946 and 1947 each taxpayer filed separate returns. For 1948, each couple filed a joint return. [R. 33.]

2. Artcraft Builders, Inc. (hereinafter referred to as Artcraft) is a California corporation. It was organized

on March 10, 1941, to engage in residential building, both under contract for others, and for sale to the public generally. Its stockholders were Mr. and Mrs. R. T. Cooke, Mr. and Mrs. J. S. A. Smith, Edward Pool and William K. Murphy. [R. 33-34.]

3. The taxpayers purchased all of the stock of Mr. and Mrs. Cooke and Mr. and Mrs. Smith on or about June 1, 1943, as a result of disagreement over the future policy of Artcraft which had arisen no later than August 18, 1942, and continued until the purchase of the Cooke and Smith stock. On August 18, 1942, Pool had proposed that Artcraft build income units. This proposal was disapproved by Artcraft's Board of Directors. Murphy and Pool desired to have Artcraft build apartments and duplexes for sale to the stockholders, who, under their proposal, would retain them for the purpose of obtaining income by renting them. Cooke and Smith, however, wanted Artcraft to continue with its established mode of business. As a result of the taxpayers' purchase of the Cooke and Smith stock, the way had been paved to carry out Pool's original proposal, which had always had the support of Murphy. [R. 36, 37, 146-147, 157-159, 168, 437-438, 507; Par. 7 Stip., R. 19, Ex. 21.]

4. Accordingly, Artcraft entered into a contract with the taxpayers on September 16, 1943, pursuant to which Artcraft agreed to build 22 apartments and 70 duplexes on Tracts 11674 and 11451 respectively, for taxpayers. The 22 apartments and 70 duplexes were built by Artcraft and on March 31, 1944, were deeded to taxpayers as tenants in common pursuant to the contract of September 16, 1943. On February 26, 1945, a similar agreement was made between Artcraft and taxpayers pursuant to which Artcraft was to build 100 duplexes for taxpayers

on Tract 13163. Artcraft was paid $35,333.21 for building the 100 duplexes. These duplexes were deeded to taxpayers as tenants in common on March 21, 1946.[2] [R. 44-46; Exs. C-3, E-5; Stip. par. 12, 20; R. 20-21, 25-26, 52.]

5. The dwelling units constituting the 22 apartments and 70 duplexes were rented as construction was completed. The first unit to be rented was in one of the 22 apartment buildings on the day before Thanksgiving in 1943. The rental terms were in keeping with the requirements of the priorities application and General Order Numbers 60-2 and 60-3 of the National Housing Administration. The initial leases were all written and were for a period of one year, although some of them thereafter may have been leased for longer periods. [R. 44.]

6. The 100 duplexes in Tract 13163 were leased as they were completed, all of the leases being for a period of one year. The dates of completion were June, July and August of 1945. [R. 54.]

7. At a meeting of the Board of Directors of Artcraft on June 14, 1944, an oral agreement between taxpayers and Artcraft was ratified pursuant to which Artcraft built a market building for taxpayers on land owned by

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[2]As the Tax Court found [footnote 5, R. 52] there was "testimony to the effect that a similar deed covering the said properties was delivered to the four individuals at or about the time of the said [February 1, 1946] Directors' meeting." In view of the entire record this is less than a complete finding, but since it appears to be immaterial to any present issue there is no reason to detail the evidence that establishes the existence of the earlier deed. This is so because even if the date of the second deed, March 21, 1946, is used the six months' holding period required by Section 117(j)(2) of the I. R. C. of 1939 is satisfied since as noted in the Statement, *infra*, the date of the deed for the first of the 100 duplexes sold was September 23, 1956. [R. 61.]

taxpayers for a fee measured by the cost of the building plus 10 per cent. At the time of the trial of this case the market was still owned by taxpayers and at all times since completion had been rented. [Stip. par. 19, R. 25; R. 47; Ex. I-9.]

8. Murphy and Pool wanted to invest in rental real estate, and did invest in the 22 apartments, 70 duplexes, 100 duplexes and the market building which it was their intention to hold for a long period of time because of the highly speculative nature of the building business which they had been engaged in. They were cognizant of the obligations to their dependents and the hazardous nature of the business of building houses on contract and for speculation. Friends and business acquaintances whose opinions they respected also advised that they invest in rental property. They desired a steady income that they could rely on as they grew older and, in addition, they had been asked by officials of Douglas Aircraft Corporation and the Federal Housing Administration to build houses to help to take care of the influx of workers to Southern California. [R. 153, 177-178, 507-508, 509.]

9. The Federal Housing Administration Subdivision Information Form relating to the 22 apartment buildings, which consisted of 68 rental units, described the apartments as being built for rent and not for sale, as did the similar form for the 70 duplexes. Question 1(m) of Exhibit 19 which reads "Number of homes to be built immediately to order" was answered "68 rental units." The second part of that question, "For sale" was filled in "no." Question 1(o) of the same Exhibit "Price range existing homes" was left unanswered, and instead there was inserted the phrase, "Rental range from $48.00 to $53.00." Question 1(p) entitled "Outline selling and

improvement program contemplated" was answered "all rentals." This Exhibit indicates that it was submitted to the Federal Housing Administration on July 21, 1943.

10. Similarly, Federal Housing Administration Subdivision Information Form relating to the 70 duplexes which also bears the date of July 21, 1943, answers question 1(m) "Number of homes to be built immediately to order," "140 Rental units," and the subquestion "For sale" was answered "no." Question 1(o) relating to the price range of proposed homes was answered, "Rental—$50.50 per month." Question 1(p) which requests "Outline selling and improvement program contemplated," was answered "none." [Ex. 20.] Both forms contain the following printed statement immediately above the space for signature as follows: "The undersigned represent that to the best of their knowledge and belief the statements, information, and conditions contained herein are correct, and the required exhibits are attached hereto in duplicate."

11. The War Production Board priority application for the 100 duplexes did not request a sales price, but included only a rental schedule. Exhibit M-13, which was a joint exhibit attached to the stipulation of facts [R. 27] answers question 2(a) at the top of page 3, column 8, "Shelter Rent," "$42.50 per unit"; and column 9, "Charge for Tenant Service, $7.70"; and "Total Rent" (column 11) "$50.25." The final column (12) "Range of Sales Prices" contains no figure. At the bottom of the page immediately preceding this schedule, under the heading "Rental and Sale Schedule" there is the statement "If dwelling units are to be sold under the provisions of N. H. A. General Order No. 60-3, also indicate in column (a) (12) the proposed sales prices including the sales prices for units which may be sold under the lease-option

provision of N. H. A. General Order Number 60-2." Finally, under the signature of W. K. Murphy on page 3 of the form, which purports to be signed as of January 4, 1945, is the statement, "Section 35(a) of the United States Criminal Code, 18 U. S. C. Sec. 80, makes it a criminal offense to make a willfully false statement or representation to any department or agency of the United States as to any matter within its jurisdiction."

12. On or about April 1, 1944, the four taxpayers formed a joint venture or partnership known as "Edward Pool and Associates." Thereafter the partnership or joint venture kept its books on an accrual and fiscal year basis ending January 31 of each year. [Stip. par. 13, R. 21; R. 46-47.]

13. Artcraft performed the services of rental agent for the partnership for the period the partnership owned the 22 apartments, the 70 duplexes, the 100 duplexes and the market building. As rental agent Artcraft entered into leases, collected rent, kept books, paid bills and generally managed the property. For these services the partnership paid Artcraft the following amounts: 1944, $7,745; 1945, $9,357; 1946, $23,614; 1947, $15,500; 1948, $12,000. [Stip. par. 14, R. 21-22; R. 55-56.]

14. The partnership income tax return of Edward Pool and Associates for the taxable years stated that the business of the partnership was "Real Estate Rentals." [Exs. U, V, and W.]

15. When Artcraft was building houses for sale, it always built single family units because they were easier to sell. Speculative builders in Southern California at that time did not generally build multiple buildings for resale. There was no market for multiple dwellings at

the time. If the partners had wanted to build for sale they would have caused single units to be built. [R. 154-157, 277, 358, 378, 394, 507-508, 521.]

16. Conversely, multiple dwellings were a more superior form of income investment than single family units. The cost of lots, streets, sidewalks, sewers, water, maintenance, etc. is greater for single family units than for mulptiple dwellings, compared to the amount of rental income obtainable. These costs for four single family houses would approximate four times the cost for one apartment with four rental units. [R. 154-155, 251, 525.]

17. It was possible to secure War Production Board priorities to build single family units, and the Board had granted such priorities in the same general area at the time Artcraft was building the 22 apartments and the 70 duplexes. [R. 155-157, 247-248.]

18. The 22 apartment buildings, the 70 duplexes and the 100 duplexes were of better quality, both in workmanship and materials used, than the houses heretofore built and sold by Artcraft. [R. 53.] They were, moreover, of better quality than was customary in houses being built for resale generally. Thomas H. Block, a plaster contractor for approximately 25 years, testified he had approximately 200 employees at the time the duplexes and apartments were being built, and that he had bid on practically all the tracts being built in Los Angeles County during this period. He was asked to bid on the duplexes and apartments, and he did not do so solely because the stringent specifications required more man hours than he had men available to do the work. They were more stringent in that they required expendable metal lath instead of the usual plaster board, notwithstanding the latter was in good supply. When Block objected to the

metal lath specifications and inquired as to the reason, he was told by Pool that the duplexes and apartments were being built for rental purposes and not for resale. Other parts of the buildings were also governed by unusually stringent specifications. These included larger foundations, better carpentry work, better stucco, more nailing and reinforcing. The interior finish and painting were also better than customary in houses built for resale. The testimony was that the reason for this was because they were to be a permanent investment of the taxpayers. [R. 221-233, 236-237, 512-513.]

19. The head of Navy Housing in the Los Angeles area in 1945 offered on behalf of the Navy to purchase the tract containing the 100 duplexes. The taxpayers refused to sell. As a result the Navy condemned another tract on which the taxpayers intended to build 192 additional units. [R. 187-188.]

20. An Official of Navy Housing talked to Murphy and Pool numerous times about the purchase of the 100 duplexes. He visited them on an average of three times a week. He also spoke on several occasions of purchasing the other duplexes and apartments on behalf of the Navy. At one time there was a conference with various Navy officials and Murphy's and Pool's attorney with respect to possible purchase. There was no disagreement about price. Murphy and Pool were insistent that none of the properties was for sale. [R. 188-189.]

21. Numerous tenants from time to time offered to buy particular units. They were consistently told the properties were not for sale and none of them was ever sold to tenants. None of the leases carried a purchase-option provision. Real estate brokers frequently inquired whether they were for sale and were always informed they

were not. Friends had advised selling immediately after the war, but Murphy and Pool rejected the advice. [R. 54, 189, 232-233, 467, 508-509.]

22. Artcraft's general auditor, George Clark, wrote to the housing director of Douglas Aircraft Corporation and stated that Artcraft would agree to hold all the rental units for Douglas employees. A letter of January 9, 1945, signed by Murphy, supplemented the letter of January 5, but stated Artcraft intended to build 400 two-bedroom units which would be rented exclusively to Douglas employees for a minimum of two years. The 400 units referred to the duplexes which had already been completed and the 100 additional units the Associates proposed to have built on the land condemned by the Navy. The policy of renting to Douglas employees continued until after the war. [R. 215-218; Exs. 26 and 27.]

23. Although there were restrictions on the sale price on which a house built on priorities could be sold until revoked by Executive Order on August 15, 1945, the restrictions were not a barrier to the sale of taxpayers' housing units at their fair market value because (National Housing Authority General Order Number 60-3-B) the restrictions were that each dwelling unit could be sold for a maximum of $6,000 (*i.e.,* $12,000 a duplex) or the fair market value, which ever was less. [R. 40-41, 370; Exs. A-1, B-2, N-13, Sec. 2.04(d), Ex. H-8(d).]

24. The market value of housing units did not rise appreciably as a result of the revocation in October, 1945, of the War Production Board's restrictions on resale prices on war priority housing. When service men returned in large numbers the market prices of houses did rise markedly in Southern California, beginning in the latter part of February, 1946, and continuing to its peak in 1947. [R. 57, 262, 376-377, 443.]

25. Attempts were made by taxpayers to secure higher rentals for property in the latter part of 1945 and early in 1946. The Rent Control Board disapproved the requested increases. After failure to secure permission to increase rents, the taxpayers' attorney, P. M. Swaffield, advised taxpayers not to renew existing leases or to sign written leases on new rentals, because the lease, under the circumstances, benefited only the tenant. He advised that if rent control should be repealed, as in his opinion it would be sooner or later, the taxpayers would be in a position to increase rentals if there were no leases. Taxpayers acted on the advice and refused to enter into written leases solely for this reason. As a result, the last written lease on the 100 duplexes was entered into on April 10, 1946. [R. 54, 176-177, 353-355, 430-432.]

26. At some time in January or February, 1946, Philip Boland, who throughout his business life had been engaged in one capacity or another as a real estate broker, was on terminal leave from the Air Force. He visited Pool and Murphy and suggested that he be allowed to sell their properties for them. The proposal was not accepted. In April, 1946, Boland again approached Pool and Murphy in an attempt to induce them to permit him to sell the 22 apartments and 170 duplexes. He argued that this was the opportune time to sell. There was a buyer's market, and the demand was great for any kind of living quarters. After a great deal of discussion and persuasion, an agreement was made to permit Boland to sell the 70 duplexes. Even after Pool gave his consent it was with reluctance and misgivings. In addition to the arguments of Boland, taxpayers' certified public accountant, Erwin Lampe of Arthur Young & Company, concluded that the properties should be sold, in view of the fact that rental income was restricted by rent control and

that in his opinion the prevailing prices were at a peak which would decline with the passage of time. He argued that the proceeds could be invested in property that would produce much greater income. His computations disclosed a substantial rental income but the tabulations which he prepared established that if depreciation should be computed on the current market value of such housing, instead of actual cost, no profit would be reflected. Murphy inquired in May, 1946, whether the gains on the sale of the properties would receive capital gain treatment. He was taken by Lampe to his senior in Arthur Young & Company, who advised Murphy the gains would be taxable as long term capital gains. [R. 57-59, 193-196, 261-264, 266, 442-443.]

27. Boland among other things pointed out that the probable sales price of the 70 duplexes would be in the neighborhood of $12,000, and that they had cost but $6,000. Despite Boland's insistence on selling all the duplexes, as well as the apartments, taxpayers agreed to sell only the 70 duplexes. These were chosen for sale rather than the 100 duplexes or the apartments because they were not quite as good buildings. Substitution of some materials had been required, due to war exigencies, when they were built. When Boland was refused permission to sell the 22 apartments and the 100 duplexes, it was the intention of both Pool and Murphy to retain them, because Pool was reluctant to sell even the 70 duplexes, and Murphy concluded they should be retained as part of a diversified investment program. Both of them hoped rent control would be eliminated which would make the remaining rental properties a better investment. [R. 195-197, 204, 259-263, 357, 378-379, 395, 426-427, 453, 471, 472, 510.]

28. Boland wanted taxpayers to pay him the customary broker's commission of 5 per cent for selling the 70 duplexes. An agreement was ultimately reached to pay him $500 a duplex, which was a little less than 5 per cent of the selling price. Boland was given the right to use Artcraft's office, telephone and certain other facilities because no other office building was available close enough to the duplexes, and there would be a long delay in securing a telephone. Boland performed all the duties of an independent real estate broker. He advertised the property, showed the houses, wrote contracts, initiated the escrows, checked credit, and did everything necessary to sell the properties. Murphy and Pool occasionally came to the office when they were in town during that period, but gave no assistance whatsoever in making the sales, other than with their wives to sign the deeds as required. [R. 59-60, 197-201, 285, 379-380, 468, 469, 516, 524.]

29. Boland worked full time on the sale of the duplexes and in addition had a woman employee and two salesmen. He also obtained "some" help from Artcraft's bookkeeper, Mrs. Woodruff. Boland personally prepared all the newspaper and other advertising pertaining to the sales. He used Artcraft's name in the advertising, although he knew Artcraft was not selling the houses. Boland felt there was nothing unusual or misleading in implying Artcraft was the seller, when in fact it was not the owner but the builder, because the tract was known as "Artcraft Manor," and he concluded that it was desirable to identify Artcraft with the sale. Murphy and Pool were never consulted about the advertisements and had nothing to do with them. [R. 207, 266-268, 280, 282, 284, 285, 380-384, 468-469, 516-517.]

30. The first deposit on the 70 duplexes was taken May 4, 1946, and within ten weeks' time sales had been

closed or deposits had been taken on all 70 of the duplexes. [R. 60.]

31. Sixty-four of the 70 duplexes were sold for $11,800 per building, and 6 for $12,200. Of the 100 duplexes, 91 were sold at $13,000 per building, 8 at $13,250, and the last was sold in 1948 at $10,592.01. [R. 64.]

32. After completing the sale of the 70 duplexes Boland took a trip to Missouri and on his return to the Long Beach area about the middle of July, 1946, he continued to urge Murphy and Pool to sell the 100 duplexes and the 22 apartments. Boland pointed out that he could obtain a higher price by selling each duplex to two vetterans, rather than to sell the duplex to a single owner as he had in the case of the 70 duplexes. Also, it was becoming increasingly clear that rent control would not soon be revoked. Finally, by utilizing "GI" terms it was possible to arrange for no down payment from the purchasers, something that had never been done in this area previously. As a result of all these considerations Murphy and Pool finally consented to the sale of the 100 duplexes, but refused to sell the 22 apartments or the market building. [R. 60-61, 202-204, 387-388, 394-395, 427, 509-510; Ex. N-14.]

33. The 100 duplexes were sold in the same manner as were the 70. Boland contracted to sell them and had full responsibility for every phase of the sale, and neither Pool nor Murphy had anything to do with the sales except for the signing of deeds, and some help from Murphy in arranging for necessary financing after the Bank of America refused to finance sales of a single building made to two persons. In Boland's words [R. 380]: "Well, for me it was merely a question of taking over the entire deal and selling it as I chose, as long as they told me what

they wanted for the building and what I was to get. I would use whatever method was satisfactory to sell those buildings." As was the case with the 70 duplexes, the advertising and the sale of the 100 duplexes was prepared by Boland personally with no help, consent or knowledge of taxpayers. [R. 205-206, 380, 383, 384, 388, 390, 391, 471, 516-517.]

34. All but 20 of the 100 duplexes were sold by the end of 1946. Most of the rest were sold early in 1947. The exact dates on which deposits were taken, the escrows started, the deeds executed, and the transactions closed are summarized in The Tax Court's Findings of Fact. [R. 63.]

35. Taxpayers held title to all of the 70 duplexes and the 100 duplexes in excess of six months. [R. 52, 63.][3]

36. In 1949, taxpayers decided to sell the 22 apartment buildings on Tract 11674. There were a number of vacancies and they were no longer a good investment. They were sold in the latter part of 1949 and the early part of 1950 through an independent broker, Marshall A. Smith, with no assistance or supervision by the taxpayers. The gain from the sale of the 22 apartments is not before this Court.[4] [R. 219-220, 473-474.]

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[3]See footnote 2, *supra.*

[4]The Commissioner determined deficiencies for 1950 arising from those transactions concluding that the apartment buildings acquired by taxpayers in 1944 and rented continuously for over 5 years was also property held for sale to customers in the ordinary course of taxpayers' trade or business. Petitions were filed in the Tax Court but the cases did not reach trial status until after the subject cases had been tried. Accordingly, the parties, in a joint motion, approved

37. The market building which taxpayers acquire in 1944 was still owned by them at the time of the trial of these cases in 1953. The various stores in the building had been rented during the entire period of ownership by the taxpayers. They had frequently been asked to sell, but had always refused because, unlike the duplexes and apartments, commercial properties were not subject to rent control, and continued to be an excellent investment. [R. 214-215, 516; Ex. I-9.]

38. The money which taxpayers received from the sale of various properties was variously invested, principally in securities. Some of it, however, was invested in a building which contained a bank and 6 retail stores. This building was built in 1948 and was held for rental purposes until disposed of by them in 1952 in a forced sale under threat of foreclosure. [R. 210-213, 514.]

39. After Artcraft ceased to build any buildings with the completion of the 100 duplexes in 1945, Murphy and Pool were semi-retired. They gave some attention to the various real estate which they owned and later to their investments in the stock market. In 1950 they organized corporations in New Mexico and Colorado, and became officers and employees of those corporations. The corporations were organized to build houses for sale in the states of incorporation. [R. 210-211, 350-351, 362-363, 514-515, 67.]

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by the Court, asked that the cases be put on the inactive calendar until final disposition of the subject cases, at which time they would either be settled or tried. The Tax Court Docket number for the William K. and Edna Murphy case is 43231, and for Edward and Lottie Pool, 43324. The two cases are still pending before the Tax Court.

40. For the fiscal years ended January 31, 1945 through 1948, inclusive, Edward Pool and Associates realized net rentals from the market building, from the apartment buildings, the 70 duplexes and from the 100 duplexes as follows [R. 65-66]:

Year Ended Jan. 31	Market Building	Tract 11674 22 Multiples	Tract 11451 70 duplexes	Tract 13163 100 duplexes	Total Net Income
1945	$ 2,235.17	$ 4,533.55	$ 9,274.23	—	$ 16,042.95
1946	15,994.60	8,399.10	11,356.05	—	35,749.75
1947	19,567.18	6,997.97	(3,886.13)	$21,597.29	44,276.31
1948	16,008.70	(2,131.51)	—	(2,491.07)	11,386.12
	$53,805.65	$17,799.11	$16,744.15	$19,106.22	$107,455.13

41. Neither Murphy nor Pool nor their wives have ever held a real estate broker's license. None of them has ever bought or sold property for his own account or for others with the exception of the property giving rise to this controversy, the 22 apartments, the market building and the bank building and various houses which Pool had built and sold as a building contractor in Cincinnati, Ohio, in the 1930's. [R. 139-144, 505-507, 523.]

42. The 22 apartments, 70 duplexes and 100 duplexes were acquired by the taxpayers solely as an investment for the purpose of securing rental income. The 70 duplexes were so held until May, 1945, when it was decided to sell them in order to convert the proceeds into a better investment. The 100 duplexes were so held until the decision was made in August, 1946, to sell them in order to convert the proceeds into a better investment. The 22 apartments were so held until it was decided to sell them in 1949 because they were no longer a good investment. The 70 duplexes and the 100 duplexes were real property used in taxpayers' trade or business held for more than six months and were not held by Associates in the taxable years involved, or at any other time,

primarily for sale to customers in the ordinary course of their trade or business. [Entire Record.]

43. The Tax Court found presumably as an ultimate fact [R. 70] that

> "Beginning with the employment of Boland the four individual petitioners herein began a business of selling real estate, and from April 1946 the 70 duplexes on Tract 11451, and from July 1946 the 100 duplexes on Tract 13163 were held by them primarily for sale to customers in the ordinary course of that business."

Summary of Argument.

1. The Tax Court concluded that from the date taxpayers decided to sell their duplexes, they held them primarily for sale to customers in the ordinary course of their business within the meaning of Section 117(j) of the 1939 Internal Revenue Code. This conclusion of ultimate fact depends on the application of principles of law and therefore under controlling decisions is fully reviewable here. Even if it should be viewed as a question of fact, the decision should be reversed, because The Tax Court's conclusion is not only "clearly erroneous" within the use of that phrase in Rule 52(a), Federal Rules of Civil Procedure, but finds no support in the record at all.

2. The purpose of Section 117(j) is to afford capital gain to the *sale* of *investment* property. This record clearly establishes that this was investment property. It was sold.

That taxpayers acquired the duplexes for a long term investment is clear from every event disclosed by the record, by the unequivocal and uncontradicted testimony of taxpayers which was itself corroborated by uncontradicted and unimpeached testimony of disinterested witnesses and

by documentary evidence. The Tax Court after failing to make a finding on this crucial issue of fact was "convinced" in its opinion that the taxpayer Pool had an original and continuing investment intention, but had doubt as to Murphy. But even disregarding Murphy's testimony as The Tax Court apparently did, which is itself reversible error under the circumstances here, the record is as clear as to Murphy's investment intention as it is as to Pool's.

3. The method of sale resulted in a large number of sales, but taxpayers had a large number of duplexes. The cases consistently hold that there is not in this field one result for the large investor and another for the small.

Nor did the manner in which the sale was carried out convert the act of liquidating the investment into a business. Taxpayers made two contracts with an independent broker who for a flat commission per duplex took full responsibility for the sales, made all the decisions and either through himself or *his* employees did all of the many acts required to sell 170 duplexes in a short period of time. Taxpayers with but incidental exceptions merely signed the deeds and received the money. This on the basis of the statute's history and the cases interpreting it was the broker's business, not taxpayers'.

The Tax Court's conclusion to the contrary stems from a reoccurring misconception of controlling authority as evidenced by its numerous reversals on this question. The facts of this case in the light of that authority make this one of the clearest cases for the application of Section 117(j) to come before the courts.

ARGUMENT.

TAXPAYERS' SALE OF THEIR DUPLEXES RESULTED IN LONG TERM CAPITAL GAIN UNDER SECTION 117(j) OF THE 1939 CODE BECAUSE THE BUILDINGS WERE ADMITTEDLY REAL PROPERTY USED IN THEIR RENTAL BUSINESS, AND THE TAX COURT'S CONCLUSION THAT THE PROPERTY WAS HELD PRIMARILY FOR SALE TO CUSTOMERS IN THE ORDINARY COURSE OF TAXPAYERS' TRADE OR BUSINESS IS ERRONEOUS.

I.

The Tax Court's Ultimate Conclusion That the Property Was so Held Is Fully Reviewable by This Court.

Section 117(j) of the Internal Revenue Code of 1939 provides capital gain treatment for "real property used in the trade or business, held for more than six months which is not * * * (B) *property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.*" There is no question here whether the apartments and duplexes were used in taxpayers' business. Referring to the property The Tax Court stated in its opinion [R. 83] "and before being placed on the market, were used in the conduct of a rental business." The only controversy before the Court is concerning the italicized portion of the definition of Section 117(j) assets, *supra*. The Tax Court concluded [R. 70] that beginning with the employment of Boland taxpayers "began" a business of selling real estate and held the property from that time "primarily for sale to customers in the ordinary course of that business." But this "finding" is a finding of ultimate fact which accurately viewed is a conclusion of law based on legal reasoning from evidentiary facts.

Based on the evidentiary facts found by the Tax Court its ultimate conclusion constitutes an error of law. Whether an error of law has been committed by a lower court, or as here a quasi-judicial body of the administrative branch of the Federal Government, is a peculiarly appropriate determination for an appellate court to make.

The short proof that this is an accurate statement of the scope of review is that merely since the time the subject cases were tried before the Tax Court, that Court has been reversed on the identical issue involved here by this Court in *McGah v. Commissioner,* 210 F. 2d 769; by the Third Circuit in *Curtis Company v. Commissioner,* 232 F. 2d 167; by the Eighth Circuit in *Dillon v. Commissioner,* 213 F. 2d 218, and in *Greenspon v. Commissioner,* 229 F. 2d 947; by the Tenth Circuit in *Victory Housing No. 2, Inc. v. Commissioner,* 205 F. 2d 371; by the Fifth Circuit in *Goldberg v. Commissioner,* 223 F. 2d 709. See also the Seventh Circuit's reversal of the District Court in *Chandler v. United States,* 226 F. 2d 403.

This Court correctly pointed out in *McGah v. Commissioner, supra,* that (p. 771): "While giving careful consideration to the finding of the Tax Court, we draw our own inferences from undisputed facts. Gillette's Estate v. Commissioner of Internal Revenue, 9 Cir., 1950, 182 F. 2d 1010; Pacific Portland Cement Co. v. Food Machinery & Chemical Corp., 9 Cir., 1949, 178 F. 2d 541." Continuing, the Court stated that: "A consideration of the entire evidence leaves us with the firm conviction that a mistake has been made in this case."

The Third Circuit in *Curtis Company v. Commissioner, supra,* reached the same conclusion, this time too with respect to the identical question involved in this case. In

the words (p. 168) of its opinion in *Sears, Roebuck & Co. v. Johnson,* 219 F. 2d 590, 591, it stated: "The District Court found as a fact that expatriation had taken place. With respect to that finding it must immediately be noted that it was in the nature of an ultimate finding of fact and on that score it is well settled that such a finding is but a legal inference from other facts and as such is subject to review free of the restraining impact of the so-called 'clearly erroneous' rule applicable to ordinary findings of fact by the trial court * * *." Citing *Lehmann v. Acheson,* 206 F. 2d 592, 594 (C. A. 3rd, 1953), and *Goldberg v. Commissioner, supra,* at page 711. The same point was made by the Fifth Circuit in *Goldberg v. Commissioner, supra,* again on the identical question involved here by quoting from its prior opinion in *Galena Oaks Corp. v. Scofield,* 218 F. 2d 217, 219 (1954):

> "Insofar * * * as the so-called 'ultimate fact' is simply the result reached by processes of legal reasoning from, or the interpretation of the legal significance of, the evidentiary facts, it is 'subject to review free of the restraining impact of the so-called "clearly erroneous" rule.' Lehmann v. Acheson (3 Cir.), 206 F. 2d 592, 594."

The Court continued:

> "As succinctly stated by Professor Moore, 'Findings of fact that are induced by an erroneous view of the law are not binding. Nor are findings that combine both fact and law, when there is error as to the law.' 5 Moore's Federal Practice, 2d Ed., Sec. 52.03 (3) * * *."

The Fifth Circuit concluded on this point that (p. 712): "We are convinced that the finding of the Tax Court was the result of an erroneous view of the law, and proceed now to state our view of the substantive law involved."

This is in accordance with the expressed views of the Supreme Court. Mr. Justice Frankfurter, speaking for the Court, stated in *Baumgartner v. United States,* 322 U. S. 665, 670, 671, 64 S. Ct. 1240, 1243, 88 L. Ed. 1525: "The conclusiveness of a 'finding of fact' depends on the nature of the materials on which the finding is based. * * * Finding so-called ultimate facts more clearly implies the application of standards of law. * * *"

That this Court has not changed its mind as to the scope of review of a so-called question of ultimate fact under the Internal Revenue Code is abundantly illustrated by its decision entered February 28, 1957, in *Earle v. Woodlaw, et al.* (not yet officially reported), reversing, and remanding to, the District Court. There an analogous question of whether a particular corporate distribution is a liquidating dividend within the meaning of Section 115(c) of the 1939 Code or "essentially equivalent to the distribution of a taxable dividend" within the meaning of Section 115(g) was involved. This Court stated that the District Court's finding that the transaction was not essentially equivalent to the distribution of a taxable dividend, together with another finding, "are at best combined findings of fact and conclusions of law, if not purely conclusions of law. (Cf. Thornley v. C. I. R., 147 F. 2d 416.)"

We think it beyond question on the strength of these decisions of this Court and the other courts of appeals that there is no question of the authority of this Court to independently examine the conclusion on which the applicability or non-applicability of Section 117(j) turns, free of the "clearly erroneous" rule. (See I. R. C. of 1954, Sec. 7482; Fed. Rules Civ. Proc., Rule 52(a), 28 U. S. C.) In any event, for the reasons which we will detail in the subsequent portions of the Argument, even if this Court were bound by the scope of re-

view in connection with primary findings of fact, namely, that reversal may not occur unless the findings of the trier of fact are "clearly erroneous," it will be abundantly clear that the ultimate finding of the Tax Court is "clearly erroneous." Indeed, as we shall show, no other finding is permissible on this record other than that the property in question was not primarily held for sale to customers in the ordinary course of taxpayers' trade or business.

II.

The Tax Court's Opinion Reflects a Misconception of the Well Settled Principle That an Investment Purpose Is a Material Factor in the Applicability of Section 117(j).

For reasons which we will document fully, *infra,* there can be no question on this record that taxpayers acquired and held the property in question as an investment with the sole objective of securing rental income. We will further establish that there is no question either that they disposed of some of this property (but retained others) for valid economic reasons that were not anticipated when the property was acquired. Finally, we will show (Argument, part III, *infra*) that when the decision to sell was finally made, the sale was accomplished as simply, expeditiously and as far as any efforts of these taxpayers are concerned, as passively as was possible so to do.

A. If these are the facts of this case, we think it is plain from the decisions of this and other Courts of Appeals for the various Circuits that taxpayers' sales come squarely within the provisions of Section 117(j).

While it is true in Section 117(j) cases, as the Tax Court, said that [R. 82], "each case must stand on its own peculiar facts and circumstances," nevertheless the facts and circumstances that direct a particular result

must stem from principles which have been evolved to give effect to the statutory language and the Congressional purpose in enacting that language. One reads the opinion below in vain if his purpose is to discover such principles.[5]

Despite the number of times this issue has been before the Tax Court its conclusions appear to have been reversed by the Courts of Appeals as often as they are affirmed. The repudiated view of the Tax Court so evidenced is that regardless of original purpose in acquiring, and continued holding, for investment, once a decision to sell is reached, particularly where, as here, the number of units is large, taxpayers are *ipso facto* holding for sale within the prohibition in Section 117(j).[6] That this cannot be the meaning of Section 117(j) is clear on its face. If no sales take place no question of gain arises. Yet once a decision to sell is reached, the property must necessarily be held for sale. If such a decision, carried out, results in a business just because, as here, there is a large number of investment units, the manifest purpose of Congress in enacting the section, to give capital gain treatment to investment property, has been nullified.

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[5]Indeed, the lack of any real standard by the Tax Court in deciding these cases is epitomized by its statement [R. 87] that there have been many cases under Section 117(j), that they all "have points of resemblance" and all have "points of difference" and the decisions in "approximately equal numbers" have been for or against application of Section 117(j).

[6]There can be no question that this is so as to Mr. and Mrs. Pool even on the Tax Court's view of the record because, as emphasized *infra,* the Court said [R. 82] it was "satisfied" that Pool had only an investment purpose and only with reluctance, "agreed to bring the rental venture to an end." Yet, it held that Section 117(j) did not apply to him.

"Congress intended to alleviate the burden on a taxpayer whose property has increased in value over a long period of time from having the profits from sales taxed at graduated tax rates designed for a single year's income. The purpose is to protect 'investment property' as distinguished from 'stock in trade,' or property bought and sold for a profit." (*Rollingwood Corp. v. Commissioner,* 190 F. 2d 263, 266-267 (C. A. 9th, 1951).)[7] Or, as the Third Circuit put it in *Curtis Company v. Commissioner, supra,* the sale of an investment property in order to invest in something else (p. 170, fn. 8) "is precisely * * * [the] sort of thing which prompted the passage of the capital gains provision. Capital gains were taxed at lower rates to relieve the taxpayer from 'excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions.' Burnet v. Harmel, 1932, 287 U. S. 103, 106 * * *"

The importance of an investment purpose for acquiring and holding property has been emphasized in a long line of decisions by this and other courts which represents the overwhelming weight of authority. The manifest failure of the Tax Court to follow this controlling authority re-

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[7]This Court in *Rollingwood* continued that (p. 267) "It is our view that this policy was not meant to apply to a situation where one of the essential purposes in holding the property is sale." Although the Court there affirmed the Tax Court's decision that Section 117(j) was inapplicable it did so on facts not only different but the opposite of those here. It was abundantly clear in *Rollingwood* that the original purpose was to sell and therefore the houses were never "investment" property. See pp. 265 and 266, and particularly fn. 2. See also fn. 10, *infra.*

quires that its decision be reversed. (*McGah v. Commissioner, supra;*[8] *Curtis Company v. Commissioner, supra; Chandler v. United States, supra; Dillon v. Commissioner, supra; Goldberg v. Commissioner, supra; Victory Housing No. 2, Inc. v. Commissioner, supra;*[9] *Ross v. Commissioner,* 227 F. 2d 265 (C. A. 5th); *Camp v. Murray,* 226 F. 2d 931 (C. A. 4th); *Smith v. Dunn,* 224 F. 2d

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[8]The first opinion of this Court is reported at 193 F. 2d 662 and the second in 210 F. 2d 769. The Tax Court's opinions are reported at 15 T. C. 69 and 17 T. C. 1458. It also involved the applicability of Section 117(j) to the disposition of war housing units. In remanding to the Tax Court this Court stated in its first opinion (p. 663): "The Tax Court found that, at the time of their sale, the 14 houses were held by petitioners primarily for sale to customers in the ordinary course of petitioners' trade or business. There was, however, no finding as to whether the 14 houses were so held prior to their sale, or as to when and how long, if at all, the 14 houses were so held prior to their sale. Such findings should be made." It is apparent that in remanding the case for this reason, this Court emphasized, as the other Courts of Appeals have repeatedly done, that the original intention of holding for investment is a material inquiry in the application of Section 117(j), although the Tax Court did not agree and apparently still does not.

[9]The point is illustrated by Judge Murdock's dissenting opinion in *Victory Housing No. 2, Inc. v. Commissioner,* 18 T. C. 466, 476, whose conclusion was approved by the Court of Appeals for the Tenth Circuit which reversed the Tax Court's decision. 205 F. 2d 371. Judge Murdock stated that neither in the majority opinion nor in other decided cases is found a "satisfactory rationale" in regard to the application of Section 117(j). He pointed out that back of 117(j) is the Congressional purpose to tax the profit on the sale of investment property which occurs because of an increase in value during the period the property was held as an investment at capital gain rates rather than ordinary income which results from sales to customers in the conduct of a business. He then emphasized that "A decision of the owner to sell must necessarily preclude every sale and after he makes that decision he is holding the property for sale" until sold. He concluded that a taxpayer such as Victory Housing, organized to construct rental properties and not to sell, "should be permitted to sell even a substantial number of its units, at least through a broker, without losing the benefit of Section 117(j), and if that can happen in any case, I do not understand what there is about this case which prevents the application of 117(j)." As already stated neither could the Tenth Circuit.

353 (C. A. 5th); *Consolidated Naval Stores Company v. Fahs,* 227 F. 2d 923 (C. A. 5th); *Delsing v. United States,* 186 F. 2d 59 (C. A. 5th); *Fahs v. Crawford,* 161 F. 2d 315 (C. A. 5th).) Compare, for example, such cases reaching a contrary conclusion, largely because the purpose for which the property was acquired was sale and not investment, as *Cohn v. Commissioner,* 226 F. 2d 22 (C. A. 9th), where it was admitted in the Tax Court (21 T. C. 90) that the purpose for acquisition was sale; *Rollingwood Corp. v. Commissioner, supra,* where this Court observed that the purpose in acquiring was not investment but sale;[10] *Saltzman v. Commissioner,* 227 F. 2d 49 (C. A. 3rd), affirming *per curiam* an unreported decision of the Tax Court, 14 T. C. M. 1955-18, C. C. H. Dec. 20,836 (M). There are many others.

Despite the fact that the "Findings of Fact" here comprise 37 pages of the printed record, there is no finding whatsoever, just as in *McGah v. Commissioner, supra,* on the question of the intention for which the duplexes and apartments were *originally acquired* and *held* until the decision to sell was admittedly made in the spring of 1946. All that the findings contain on this crucial issue is the conclusion [R. 70] that "Beginning with the employment of Boland, the four individual petitioners herein began a business of selling real estate * * *"[11] But this is simply a reflection of the repudiated view that re-

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[10]This Court stated (p. 266) "* * * We think it is fair to say that one of the essential purposes (in acquiring or holding the houses) is the purpose of sale." And in fn. 2 (p. 266) it distinguishes cases cited by the petitioner on the ground that "no facts in the record in the instant case compel the assumption that the houses involved were investment property."

[11]There is comment in the "Opinion" on the question of original and continued investment intention as to Pool, but doubt as to Murphy's. The accuracy of these statements we discuss, *infra.*

gardless of whether investment property is being sold, Section 117(j) is inapplicable because the sale itself will with rare exceptions constitute a business. Since this was done long after the property had been acquired and continuously rented, the purpose for which held prior to the decision to sell has manifestly been omitted.

B. The Tax Court's ultimate finding [R. 70] was merely that *beginning* with the "employment" of Boland, taxpayers "began a business of selling real estate." This finding is not in any respect inconsistent with a conclusion that prior to *that* time the duplexes and apartments were held *solely* for investment. Moreover, in the opinion itself the Tax Court stated [R. 82] that as to "original purpose" it was "satisfied" that it was the "intent and hope" of Pool to "hold them for the production of income through the rental thereof, and that it was with reluctance that he agreed to bring the rental venture to an end and place the 170 duplexes on the market."

We take it that this constitutes an unequivocal conclusion by the Tax Court that Pool not only held solely for investment but in addition was reluctant to sell even when the decision to sell was finally made.

But the Tax Court continued in comments more inexplicable and less justified than any we have observed in our experience with the judicial process [R. 82]: "As to Murphy, however, the record is not so clear. Having observed him in the course of his testimony, taking into account the self-serving character of such testimony and the phrasing of many of the questions to which he responded we are not persuaded that at any time he had

any intent or purpose than to rent or sell the properties, dependent upon which in the end, should appear to him to be the most fruitful or profitable venture."[12]

The Tax Court's refusal to give full credence to the unimpeached and uncontradicted testimony of Murphy as to the purpose for which he acquired and held the property was error in itself. In the words of this court, *Grace Bros. v. Commissioner,* 173 F. 2d 170, 174, "It is axiomatic that uncontradicted testimony must be followed. Chesapeake and Ohio Railway Company v. Martin, 1931, 283 U. S. 209, 216, 217, 51 S. Ct. 453, 75 L. Ed. 983; San Francisco Association for Blind v. Industrial Aid for the Blind, 8 Cir., 1946, 152 F. 2d 532, 536; Foran v. Commissioner, 5 Cir., 1948, 165 F. 2d 705." The court continued that the only exception occurs when "we are dealing with testimony by witnesses who stand impeached and whose testimony is contradicted by the testimony of others or by physical or other facts actually proved or with testimony which is inherently improbable."

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[12]The Court continued that as to Mrs. Pool and Mrs. Murphy, "the record is wholly silent, and aside from any right of the husband to manage the property of the community, it may well be that, in each instance, the purpose and intent of the husband was the purpose and intent of the wife." We take it that it was the Tax Court's view that Murphy's and Pool's intent and purpose is to be attributed to their wives. In any event this is the fact and moreover as a matter of law, Pool and Murphy were the managers of the community. The record shows nothing to rebut the normal presumption. Finally, the record is not "wholly silent" on this point. Pool testified [R. 506] that his wife had never been active in his business and that although they had been married forty-three years she had never worked since their marriage. Murphy testified that his wife was never in the office more than once "ever"; that she did not have a real estate broker's license and had never been associated with real estate of any kind. [R. 200.]

The court concluded "the same principles" have been "repeatedly" applied.[13]

But the Tax Court's error was compounded because Murphy's testimony was not only uncontradicted and unimpeached and not inherently improbable, but on the contrary, confirmed throughout the record by all the events which took place from 1942 to 1950 and at every material point by disinterested witnesses and documentary evidence. We know that a study of the record will permit of no other conclusion.[14]

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[13]*Foran v. Commissioner, supra,* is particularly apropros because the Tax Court there also refused on the basis of the taxpayer's testimony to find an investment purpose under Section 117(j). In reversing the Court of Appeals stated (p. 707), "Here there is direct and positive evidence from the witness who best knows that this property was for 18 months being held for investment and not for sale to customers. His testimony is consistent with every proven fact. He gives a credible reason why it was not for sale and why finally in 1941 he did sell it." The court concluded, "We think the court's refusal to follow the sworn testimony is contrary to law, and requires the setting aside of its fact-finding as it would that of a jury." See also *Ross v. Commissioner,* 227 F. 2d 265 (C. A. 5th, 1955); *Herbert v. Riddell,* 103 Fed. Supp. 369, 388, 389, where Chief Judge Yankwich of the District Court concluded (p. 389), "The testimony of *one credible witness* as to a fact, if not contradicted, and if not inherently improbable, is sufficient to establish such fact. The principle obtains in the law of taxation."

[14]The surprising and, to us, shocking comment of the Tax Court that it could not be sure of Murphy's intention, despite his positive testimony is not diminished by the reasons which the Tax Court gives for this conclusion. The first [R. 82] that "Having observed him in the course of his testimony * * *", implies much but tells little. There is nothing to indicate what there was about his testimony that made his positive, consistent and everywhere documented statements unworthy of the Tax Court's belief. The second [R. 82-83], that his testimony was "of a self-serving character" is, of course, true. But where as here the Internal Revenue Code places the burden of proof upon a taxpayer in part concerning a subjective intention, it is a strange rule of law that would exclude from serious coinsideration the only person who could give it, *because* he is giving it. In *Foran* (fn. 13, *supra*), the Fifth Circuit instead of discrediting such testimony in effect said it was entitled

C. On the basis of primary facts found by the Tax Court alone, *even disregarding Murphy's testimony* as to subjective intent, we think that this *record presents one of the strongest ever to be considered,* showing a firm and undeviating intention to acquire and hold as investment property for the purpose of obtaining rental income. When supplemented by other facts not found by the Tax Court but compelled by the record, the evidence is overwhelming. Indeed, there is nothing in the record that points the other way. These points may be briefly summarized as follows:

1. The Tax Court Was "Satisfied" That Pool Had Solely an Investment Purpose.

The Tax Court has stated in its opiinon [R. 82] that it was "satisfied that it was the intent and hope of Pool to hold them [duplexes] for the production of income through the rental thereof, and that it was with reluctance that he agreed to bring the rental ventures to an end and place the 170 duplexes on the market." There would

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to special credence because it was "direct and positive evidence from the witness who best knows," and as was said in *Herbert v. Riddell* (fn. 13, *supra*), (pp. 388-389) "But we are not permitted to disregard the unrefuted testimony of a reputable witness *merely because he is a taxpayer.*" The third reason [R. 83] "the phrasing of many of the questions to which he responded," is not otherwise explained, but perhaps the court is suggesting that leading questions were put to the witness. A reading of the record, however, will disclose that neither the government nor the court objected to the form of phrasing of the questions to Murphy. Moreover, a study of that record will show that although there were some questions in form leading, as indeed there must inevitably be in any trial of complicated issues, Murphy was a singularly unleadable witness. Finally, the record will show that almost all of the testimony concerning his intention on direct examination was not in response to leading questions and moreover much was as a result of cross-examination.

appear then, even on the Tax Court's analysis, to be no question about Edward and Lottie Pool's undeviating investment intention.

2. Taxpayers Had a Fully Documented Plan Actually Carried Out to Build and Hold Investment Property That Goes Back to 1942.

(a) The intention of the parties to acquire and hold investment real estate began in 1942, when a plan was conceived by Pool to have Artcraft build rental property for acquisition by its stockholders. [State., par. 3.][15]

(b) Pool proposed at a meeting of the Board of Directors of Artcraft on August 18, 1942, that the corporation build "27 income units * * * but this proposal was turned down." [Pet. Ex. 21.] The minutes of Artcraft of February 17, 1943, disclosed that Pool "also reopened the subject of building residential income in two, three and four unit apartments. The subject was discussed and decided not to take any action at this time, but to hold it open for future consideration." [Pet. Ex. 22; State., par. 3.]

(c) The stockholders were to acquire the property and keep it as a permanent investment. [State., par. 3.]

(d) Smith and Cooke, two of the stockholders of Artcraft, objected. Pool's purpose was to have Artcraft build the property, because it was in a position to build since that was its business.

(e) As a result of a deepseated controversy over this question Pool and Murphy ultimately purchased Smith's

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[15]In the interest of conciseness, references will be made to paragraph numbers of our Statement of Facts, *supra*, which are fully annotated to the record.

and Cooke's stock, at which time the way was paved to cause Artcraft to build the 22 apartments. The Tax Court found that [R. 37] Murphy and Pool and their wives purchased all of the stock of the Smiths and Cookes on or about June 1, 1943.[16] [State., par. 3.]

(f) The Federal Housing Administration approved the construction of the 22 apartments on June 1, the same date on which the stock of the Smiths and Cookes were purchased by the Pools and Murphys, and the War Production Board approved the construction six days later, on June 7. [R. 38.]

(g) Pools' and Murphys' plan to acquire duplexes and apartments from the corporation was carried out. The corporation built and the Murphys and Pools acquired 22 apartments of 68 rental units; 70 duplexes; 100 duplexes and a market building. [State., par. 4.]

Accordingly, the record is clear as to a singleness of purpose dated back to 1942 to cause Artcraft to build for its stockholders investment property that would be retained by them as such.[17]

3. There Were No Government Restrictions That Prevented Sale of the Duplexes and Apartments.

Government requirements with respect to war housing were not a factor in taxpayers' investment purpose. Taxpayers' decision to invest in rental housing was directed

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[16]As the Tax Court noted in a footnote in its findings [R. 37, fn. 2], "It was the testimony of both Pool and Murphy that neither Smith nor Cooke desired to engage in the construction of rental housing."

[17]There is no question either, even disregarding Murphy's testimony, that Murphy was in full agreement with Pool's plans. Pool was asked [R. 507-508]: "Q. Was Mr. Murphy agreeable to this? A. Yes, he was agreeable to it."

by their own evaluation of their best economic interests, aided by the advice of friends. They were cognizant of the highly speculative nature of the building business their corporation had been engaged in, and desired a steady income that they could rely on as they grew older. Moreover, they had been asked by officials of Douglas Aircraft and the Federal Housing Administration to build houses to take care of the influx of war workers in Southern California. [State., par. 8.]

4. Contemporaneous Statements to Government Housing Agencies Under Penalty of Perjury Stated the Sole Purpose of the Construction Was Rental.

Sworn statements to the government housing agencies involved signed by Murphy show a contemporaneously expressed intention to build solely for rental, and a categorical statement that the houses were not for sale. [State., pars. 9, 10 and 11.]

5. Taxpayers Were Not Real Estate Brokers and Did Not Buy and Sell Other Property for Speculative Profit.

None of the taxpayers was a real estate agent, and they purchased no other property during this period or after with the intention of selling at a profit. [State., pars. 39, 41.]

6. Written One-Year Leases on All Units.

Everyone of the 308 rental units which they owned were leased for a period on written leases of one year or more. [State., pars. 5 and 6.]

7. None of the Leases Contained Options to Purchase.

[Ex. C-7, Stip. par. 14, R. 21-22.]

8. The Type of Construction Enhanced the Value of the Units for Investment but Not for Sale.

The construction of the dwelling units was superior to that normally used in houses built for sale, because of taxpayer's belief that this would enhance the value of the property as a long term investment by reducing maintenance costs. The superior nature of the construction was not intended and did not make the units more saleable. [State., par. 18.]

9. There Were No Government Restrictions That Would Have Prevented the Sale of These Housing Units at Any Time.

There were no effective restrictions on the sale of this property, even prior to the revocation of all restrictions on August 15, 1945. The restrictions were that each dwelling unit could be sold for a maximum of $6,000, or the fair market value, whichever was less, and during this period the property could not have been sold at a price in excess of the allowable selling price, because its value was not as high as the ceiling price. [State., par. 23.]

10. The Removal of All Restrictions Did Not Motivate the Sales.

After all restrictions were removed on August 15, 1945, taxpayers made no attempt to sell, but in fact refused offers. Leases were continued as late as April 10, 1946. [State., pars. 23, 25, 27, 32.]

11. Taxpayers Could Have Built Single-Family Homes for Which There Was a Ready Market.

Taxpayers could have obtained priorities to build single homes for which there was a ready market, but chose to build duplexes and apartments for which there was no ready market. [State., pars. 15, 16 and 17.]

12. Taxpayers Made no Attempt to Sell Until a Decision to Liquidate the 70 Duplexes Was Reached and Repeatedly Refused to Consider Inquiries of Possible Purchasers and Brokers.

There were repeated refusals by taxpayers to sell the property:

(a) An official of Navy Housing on numerous occasions sought to purchase the 100 duplexes. [State., par. 20.]

(b) Numerous tenants from time to time offered to buy particular units. [State., par. 21.]

(c) Real estate brokers frequently inquired whether they were for sale. [State., par. 21.]

(d) Friends had advised selling immediately after the war, but the advice was rejected. [State., par. 21.]

13. There Was Written Evidence of an Offer as Late as January 9, 1945, to Douglas Aircraft to Rent to Their Workers Exclusively for Two Years.

In addition to individual leases, Murphy wrote to Douglas Aircraft on January 9, 1945, and offered to hold the duplexes, the apartments and an additional 100 duplexes taxpayers were proposing to build solely for Douglas employees for a period of two years. The policy of renting to Douglas employees continued until after the war. [State., par. 22.]

14. Even When the Decision to Sell the 70 Duplexes Was Reached, There Was No Intention to Sell the Remaining Units.

The decision was reached solely because of the rapid appreciation in real estate values in the spring of 1946, coupled with the limiting factor of rent control on the

income of the investment, which had so markedly increased in value. These things were pointed out to taxpayers by the real estate agent Boland, by their certified public accountant, Erwin Lampe, and by others. The purpose was to reinvest in property not subject to control of income and to diversify taxpayers' investment. The decision to sell the 100 duplexes was not made until several months after all of the 70 had been sold. As a result of the still further increase in the market value of this property and the urging of the agent Boland a decision to sell the 100 duplexes was made.[18] [State., pars. 26, 24.]

15. Taxpayers Continued in the Rental Business After These Tax Years.

(a) After the 100 duplexes were sold taxpayers continued to own the 22 apartments until the latter part of 1949 (seven years after the original intention to go into the rental business was first proposed, and six years after the first of the properties was built), and the early part of 1950, when they were sold through an independent real estate broker, due principally to the fact that there were

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[18]The Tax Court noted in footnote 8 of its opinion [R. 58] that "It was Pool's testimony that Murphy got rather enthusiastic as prices went up, but that he, Pool, still didn't want to sell them. He also testified, 'We got so much advice from Mr. Boland, Mr. Boland was so persistent on what they could do, the prices he could get, and naturally there was quite a profit on them, and they just finally overrode me, that's all."

While it is accurate that Murphy was easier to persuade as to the economic wisdom of selling the housing investment, it was erroneous to infer from this, as the Tax Court apparently did in part, that Murphy did not have an original and long continuing firm intention to acquire and hold rental housing. The record everywhere confirms the fact that Murphy's decision was solely the result of economic factors that had not and could not have been foreseen.

a large number of vacancies so that they were no longer a very good investment. [State., par. 36.]

(b) They continued to own and hold for rental purposes at the time of the trial of this case in 1953 the market building which taxpayers had acquired during the period when the duplexes were being built. [State., par. 37.]

16. Taxpayers Used the Proceeds of the Sales to Invest in Other Investments, Principally Securities.

The money which taxpayers received from the sale of the properties was variously invested, principally in securities. [State., par. 38.]

17. Taxpayers Neither Before, During nor After Ownership of These Properties Bought and Sold Other Real Estate for the Purpose of Profiting on the Resale.

Taxpayers, neither as a partnership nor individually had to the date of the trial of these cases purchased or sold[19] any other real estate.[20] After Artcraft built the last of the 100 duplexes in 1945, Murphy and Pool were semi-retired and devoted attention to the various real estate which they owned and to their investments in the stock market. In 1950 they organized corporations in New Mexico and Colorado and became officers and em-

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[19]The only exception was the building of a bank building and six rental stores in 1948, which were rented and held solely for that purpose. They were disposed of in 1952 at a forced sale under threat of foreclosure. [State. Par. 38.]

[20]With but one exception Pool, many years before as a building contractor in Cincinnati, Ohio, in the 1930's had built houses for sale. [State. Par. 41.]

ployees of those companies.[21] [State., pars. 38 and 39.] This case then, unlike many of the troublesome cases under Section 117(j), is not one where the taxpayers were generally speculators or traders in real estate and claimed the particular property as part of a separate investment portfolio, but rather one where at no period relevant to the controversy any of the taxpayers in any sense were real estate traders. This factor alone makes the question of their original investment intention much easier to ascertain than such cases as *Galena Oaks Corporation v. Scofield,* 218 F. 2d 217 (C. A. 5th), which as discussed in detail in Point III *infra,* the Tax Court stated [R. 88] "offer(s) the strongest support for our conclusion" here.

18. Tax Returns of Partnership Showed Business as "Real Estate Rentals."

The partnership income tax return of the four taxpayers who did business under the name of Edward Pool

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[21]It is clear from these indisputable facts that except for the property involved in these cases and the question of the gain on the 22 apartments still pending before the Tax Court (fn. 4, *supra*) taxpayers neither individually nor collectively, before, during or after the period involved in these cases, dealt speculatively in real estate by buying and selling for a profit. The fact they had stock and were officers of corporations which carried on this activity is not relevant as to their personal status as real estate investors. Artcraft Builders, Inc., the California corporation, as well as Artcraft of New Mexico and Artcraft of Colorado, were taxable entities separate and apart from the individual taxpayers. The doctrine of the separateness of corporate entity has been repeatedly affirmed in income tax cases. The Supreme Court has applied it in distinguishing between the business of a corporation and its stockholders (*Burnet v. Clark,* 287 U. S. 410, 77 L. Ed. 397; *Dalton v. Bowers,* 287 U. S. 404, 77 L. Ed. 389; see also *New Colonial Ice Co. v. Helvering,* 292 U. S. 435 78 L. Ed. 1348). The same court has made it clear that the business of a corporation is not the business of a stockholder or of an officer (*Deputy v. DuPont,* 308 U. S. 488, 84 L. Ed. 416).

and Associates for each of the taxable years stated that the business of the partnership was "real estate rentals." [State., par. 14.]

19. Sound Rental Investment.

The investment proved to be a sound one. In the taxable year ended January 31, 1945, there was net income after all expenses, including depreciation, of $16,042; for the year 1946, $35,749; and for the year 1947, $44,276. [State., par. 40.]

20. Summary.

We think it plain that this case has in it, based on undisputed facts, every factor emphasized in other Section 117(j) cases, showing an investment purpose and none of the factors showing a speculative or trader purpose: To enumerate, the purpose of acquisition of the property was long term investment, not a purpose to await a favorable sales market or the removal of government restrictions; the leases were one year written leases or longer—there were no oral month to month leases or leases with option to buy; the investment was a good rental investment showing substantial net profit each year; there was constant refusal to sell, either as a whole or separately, despite requests from tenants, brokers, the Navy and others; taxpayers were not real estate brokers or otherwise engaged in buying or selling property for their own account or for others either during this time or at any other time;[22] the purpose of the disposition of the property was to liquidate an investment which, while it had been a sound one, was no longer one to retain because the same money invested in other property not subject to control

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[22]See footnote 21, *supra*.

of income would show a much better return due to the tremendous increase in real estate values in Southern California in 1946 and the continuance of rent control, neither of which had been anticipated by Murphy, Pool or their advisers; the purpose motivating the liquidation, as indeed all the purposes relied on here, was actually carried out and the money was invested largely in listed securities; and finally, there was direct testimony of both Pool and Murphy of their intention, everywhere supported in the record and nowhere contradicted or impeached.

III.

Taxpayers' Decision First to Permit the Real Estate Agent Boland to Sell the 70 Duplexes and Later to Sell the 100 Did Not Constitute the Beginning of a Business in Which the Taxpayers Held the Property Primarily for Sale to Customers in the Ordinary Course of Their Trade or Business.

Assuming that the investment intention existed and continued until April and July of 1946, as established in Part II, *supra,* the Tax Court's conclusion that the two contracts with Philip Boland authorizing the sale by him of the 70 and 100 duplexes put taxpayers in the business of selling to *their* customers in the *ordinary* course of that business deprives the phrase "his customers" and "ordinary" in Section 117(j) of any meaningful content.

The purpose of Section 117(j) as previously emphasized is to permit the *sale* of investment property. But once a decision to sell is made, the property is of necessity *held* for sale. The statutory prohibition is not holding for sale but rather to *taxpayer's* "customers" in the *"ordinary course"* of *his* business.

A. A large number of sales in a short period of time, it has been repeatedly held "does not establish a real estate business or the sale of property in the ordinary course of such a business." (*Curtis Company v. Commissioner, supra;*[23] *Chandler v. United States, supra.*[24]) The courts do not deny capital benefits "simply because a large number of sales are made in a short period." (*Goldberg v. Commissioner, supra,* p. 712.) The only significance of large numbers is that taxpayer "had a lot of houses to sell * * *." (*Ross v. Commissioner, supra,* p. 268.)

The reason is that manifestly the nature of the property directs the way it should be sold. As the Seventh Circuit noted in *Chandler v. United States* (p. 406), "The market place is hardly glutted with prospective buyers clamoring "for such amounts of property." "By the very nature of the case * * * [taxpayers] had to sell the properties a piece at a time." (*Curtis Company v. Commissioner, supra.*) The court continued (pp. 169-170), "Surely that does not make him a dealer in these parcels of land any more than it would make a man a dealer if he wanted to liquidate his holdings in a corporate stock for which the market was weak so that he had to sell by small parcels instead of by one sale. That is the taxpayer's situation here." The Tenth Circuit in *Victory Housing No. 2, Inc., supra,* analogized the large number of rental houses sold there to the situation of a farmer owning 20 separate farms used in a farming business, desires to cease farming and disposes of his holdings by selling them in a short time. It thereupon reversed the

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[23]1098 rental housing units disposed of in tax years.

[24]In 8 tax years the trust sold 290,000 acres of land in 536 separate sales, an average of 59 per year.

decision of the Tax Court in accord with the Tax Court's decision in the instant cases.

B. The statute denies capital gain if there are sales to *taxpayer's* customers in the "ordinary" course of its business. Consistent with that requirement the courts have emphasized that whether a broker acting as an independent contractor with the minimum of supervision that the term "independent contractor" implies under traditional common law concepts is used in the liquidation of an investment, is a significant factor in concluding that the sale is neither to taxpayer's customers nor in the ordinary course of his business. (*Dillon v. Commissioner,* 213 F. 2d 218 (C. A. 8th); *Smith v. Dunn,* 224 F. 2d 356; *Camp v. Murray,* 226 F. 2d 931 (C. A. 4th); *Say v. United States* (D. C. S. D. Calif.), decided Jan. 22, 1957 (not yet reported but found in 1957 C. C. H., Fed. St. Tax Rep., Par. 948). See also *Curtis Company v. Commissioner, supra; Consolidated Naval Stores Company v. Fahs,* 222 F. 2d 923, 926 (C. A. 5th); *Goldberg v. Commissioner, supra.*)

In *Smith v. Dunn, supra,* the court emphasized (p. 356) that it was proper to consider whether the sales were in the ordinary course of taxpayer's business "or were carried on independently of the taxpayer's business." It pointed out that the taxpayer employed a broker who acted as an independent contractor. "The taxpayer, as a matter of practice, gave no time to the sale of the lots except that consumed in signing deeds, exercised no supervision or control over prices or advertising or the activities of the broker at all." (P. 357.) These are the facts of this case too. The conclusion from this was that (p. 357), "The efforts of the broker were carried out independently of the taxpayer's business and were conducted as a part

of the broker's own business and at his own expense and without anything but the most general supervision on the part of the taxpayer."

Here, it is clear that the broker Boland after the agreement was reached to pay him a flat sum of $500 per house, took full responsibility for all of the sales and performed all the duties of an independent contractor in the real estate field. He wrote and paid for the advertising copy, showed the houses, wrote the contracts, initiated the escrows, checked the credit—in short, did everything necessary to sell the property.[25] [State., par. 28.]

The Tax Court concluded that whether an independent real estate broker is used is irrelevant.[26] [R. 84.] This, we have already shown, is contrary to the decided cases.

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[25]For example, he testified in response to the question as to what his duties were [R. 380]. "General duties as a real estate broker. Q. What are they? A. Well, for me it was merely a question of taking over the entire deal and selling it as I chose, as long as they told me what they wanted for the building and what I was to get. I would use whatever method I presumed was satisfactory to sell those buildings. * * * A. I reserve the right when I make a deal to sell the way I want or—" [R. 383].

[26]The Tax Court cites cases to the effect that the liquidation of property may or may not be the conduct of a trade or business, depending upon circumstances. This is a proposition which is correct insofar as it goes, as we show *infra*. Its conclusion "that for the same reasons" the use of the broker is immaterial finds no support in these cases and is indeed a *non sequitur*. Its sole other authority for disregarding one of the controlling facts of this case, the use of the broker, is that taxpayers "unwittingly" admitted the correctness of this proposition by agreement that Artcraft used a broker when it built houses for sale and nevertheless reported the income as ordinary income. This astonishing conclusion is based on a fundamental misconception, since the first requirement of Section 117(j), *i.e.*, that property subject to depreciation be used in the trade or business of a taxpayer, was not and could not have been satisfied by Artcraft, the business of which was to build houses for sale, and therefore the manner of the sale, whether by broker or otherwise, had no relevance.

Obviously not sure of this position, the Tax Court then broadly implies without quite stating that perhaps Boland was not an independent broker, giving as a reason that he didn't receive [R. 86] "the regularly established commission of five per cent on sales." But the test of whether he is an independent broker is not the rate of his commission but[27] (27 Am. Jur. 485):

> "It has been held that the test of what constitutes independent service lies in the control exercised, the decisive question being as to who has the right to direct what shall be done, and when and how it shall be done. It has also been held that commonly recognized tests of the independent contractor relationship, although not necessarily concurrent or each in itself controlling, are the existence of a contract for the performance by a person of a certain piece or kind of work at a fixed price, the independent nature of his business or his distinct calling, his employment of assistants with the right to supervise their activities, his obligation to furnish necessary tools, supplies, and materials, his right to control the progress of the work except as to final results, the time for which the workman is employed, the method of payment, whether by time or by job, and whether the work is part of the regular business of the employer."

As already indicated, all of these tests have been met here. [State., pars. 28, 29.] (1) Boland had complete independence in selling; (2) there was a contract calling for payment of $500 a house; (3) it was a contract for

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[27]Indeed, there was direct testimony from Boland that although 5 per cent was traditional, brokers were free to agree on any other amount and that it was only in the absence of an agreement that the Real Estate Board supported the broker on a 5 per cent figure. [R. 379.]

a specific job; (4) the business of a real estate broker is a well recognized, distinct occupation; (5) Boland employed a secretary and two salesmen and had sole authority to supervise them; (6) Boland paid all expenses except that he was furnished an office and telephone not otherwise available.

It is equally clear on the record that taxpayers had nothing material to do with the sales that could be fairly interpreted as placing them in the business of selling to their customers. The testimony of Murphy, Pool, Boland and Mrs. Woodruff is that taxpayers were practically never present when the sales occurred, that they were often out of town, that Pool did not even talk to Boland about the sales, and that while Murphy on several occasions gave some advice, it was not followed. [R. 384.]

Nor is the Tax Court's apparent conclusion [R. 86-87] bolstered by the factors which it points to, namely, as already discussed, that Boland received $500 per house rather than 5 per cent, that he used Artcraft's office and telephone, that he occasionally received help from Artcraft's bookkeeper, Mrs. Woodruff,[28] and that Murphy "personally took over and worked at" the financing of the 100 duplexes. The explanation in the record as to the office and telephone was simply that there was no office other than Artcraft's near the duplexes, so it was necessary that Boland use it, and he in a sense paid rent for it by accepting a smaller commission than he had first

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[28]The record is clear that Mrs. Woodruff took her orders from Boland; that he had his own full-time secretary, and on the sale of the 100 duplexes two salesmen in addition, and that Mrs. Woodruff assisted him only "sometimes" and "to some extent." [R. 384, 385, 392, 398.]

asked.[29] As for the telephone, Boland was in the position that thousands were at the end of the war, none was available. He testified that he tried to get one but couldn't. [R. 393.] Moreover, the Tax Court is less than accurate when it states that Murphy worked the financing out, since Mrs. Woodruff and Boland's testimony was that Boland and Murphy did it together.[30] In any event, a few days spent in securing the financing of only part of the duplexes by one of the taxpayers hardly puts the four of them into the real estate business.

The emphasis on these things by the Tax Court in light of the tremendous time and countless decisions that had to be made by Boland, suggests that it is straining at gnats to reach its conclusion. And when it says, as it did [R. 87], "All the facts considered, it would be difficult to imagine a selling operation or business which was more actively conducted and carried on than the one here." we can perhaps agree, but the question which we ask and the Tax Court should have, is "Whose business was it—taxpayers' or Boland's?" The answer must inevitably be the latter's, and the conclusion directed by this is that it would be difficult to imagine taxpayers disposing of 170 duplexes with any less activity on their part.

Finally, in support of the proposition that reliance on an independent contractor is an important factor when used to liquidate investment property, to establish that taxpayers are not holding for sale to their customers in the ordinary course of their business, we note that a duly authorized representative of the Commissioner has within the last year in open court conceded in a case where a

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[29]R. 380; 198-199.

[30]R. 388, 389-390; 483.

broker was not used, "Had taxpayer employed a firm of brokers to sell the properties for it the sales then would not be in the ordinary course of taxpayer's business." (*Curtis Company v. Commissioner, supra* (p. 169).) And the Court of Appeals for the Third Circuit indicated its agreement with that concession with the citation of *Dillon v. Commissioner, supra,* and *Smith v. Dunn, supra,* which, we have already emphasized, so hold.[31]

C. The consistent conclusion of the courts then is, as to the significance of the words "ordinary" and "custom-

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[31]Government counsel at the trial of this case was well aware of the vital importance of the use of an independent broker and through strenuous cross-examination of Mr. Murphy tried to elicit an admission that taxpayers had paid Boland $85,000 for selling these properties which involved very little work, solely because they had been advised that it would improve their chances of getting capital gain. In response to one such question [R. 284], Murphy testified that they employed Boland because "We weren't in the real estate business and we didn't want to be bothered with them. There was a lot of effort required. In order to make a sale, you have to first show the property. Then you would have to sell it to the people. Then you would have to arrange the financing. Then you would have to open an escrow. Then you would have to check their credit. I don't know what else is required, but I know that much is required and we didn't do any of that." In response to the question that wasn't it rather peculiar for them to pay Boland $85,000 for doing this work when Pool and Murphy were not themselves busy with other work, Murphy replied, "It doesn't to me. That was the contract I made and I usually live up to my contracts. I did not intend to pay Boland, and I don't think Mr. Pool did, $85,000 for selling those buildings and then turn around and do the work for him."

Finally, government counsel expressly disclosed the purpose of his line of cross-examination [R. 286] by the question, "Isn't it true, Mr. Murphy, in making the decision on whether or not you would sell the 70 and the 100 duplexes, you were advised taxwise that it would be better to have someone else sell them rather than you? A. That is absolutely not true, positively, no."

We have the spectacle of the Commissioner here charging that taxpayers employed a broker in order to avoid taxes, the Tax Court concluding that a broker is irrelevant, and the representatives of the Commissioner in open court in another case admitting that this is a controlling factor.

ers" in Section 117(j), that the amount of property being sold in itself is immaterial, and whether taxpayers or an independent contractor sells, is highly material.

This conclusion is clearly confirmed by its legislative history. Section 117(j) was added to the 1939 Code by Section 101 of the Revenue Act of 1942. Its purpose is fully documented by this court in its *Rollingwood* opinion, discussed *supra*. But the trade or business limitation in Section 117(j) itself derives from one of the exclusions of the definition of capital asset in Section 117(a)(1)(A). Prior to the Revenue Act of 1934 the words "customer" and "ordinary" were not in the statute. The Committee Reports relating to the 1934 Act disclose that these words were added for the express purpose of *narrowing* the *limitation* on the definition of capital assets. The reason for this was that the 1934 Act became law during the depression and Congress was interested in broadening the definition of capital gain in order to broaden the definition of capital loss, which would by the same token reduce the number of *ordinary* losses, of which here had been so many at the time the 1934 Act was being considered. Specifically, the Committee Reports disclose that the amendments were to make it impossible to contend that a stock speculator, trading on his own account, was not subject to the provisions of Section 117(a)—*i.e.,* his sales were intended to result in capital losses (not the more useful ordinary losses) and therefore as a corollary his gains were to be capital gain. (H. Rep. No. 1385, 73rd Cong., 2d Sess., p. 22, 1939-1, Part II, Cum. Bull. pp. 627, 632.) By the insertion of the words "customers" and "ordinary" in the statute it was intended that even although assets were held primarily for sale, they were not to be denied capital asset status (or achieve ordinary loss status) if their intended sale was not to be in the ordinary course

of taxpayer's business. (*O. L. Burnett v. Commissioner,* 40 B. T. A. 605, 607, 609, aff'd on this point, 118 F. 2d 659 (C. A. 5th); *Fuld v. Commissioner,* 139 F. 2d 465 (C. A. 2d); *Thompson Co. v. Commissioner,* 43 B. T. A. 726; see also *Helvering v. Hammel,* 311 U. S. 504-512, 85 L. Ed. 303; Shaw, "When Does a Seller of Real Estate Become a Dealer," 1950 U. S. C. Tax Institute, 325-327.) The word "ordinary" has the connotation of normal usage or custom. (*Deputy v. DuPont,* 308 U. S. 488-489, 84 L. Ed. 416.)

The reason that the addition of the words "customers" and "ordinary" to Section 117(a)(1)(A) accomplished its purpose of extending the definition of capital loss (and consequently of capital gain) to stock speculators, trading on their own account, is not, of course, that they do not hold securities primarily for sale because by definition they do. Rather, the addition of these words accomplished this result because they do not sell to *their customers* in the "ordinary" course of their business. On the contrary, they sell through independent stock brokers who sell in turn to *their customers* in the ordinary course of *their business.* (*O. L. Burnett v. Commissioner, supra; Van Suetendael v. Commissioner,* decided September 25, 1944, P-H Memo Op. par. 44,301, aff'd 152 F. 2d 654 (C. A. 2d); see also Clark, "Distinguishing Between Dealer and Investor Sales by the Same Taxpayer," 8 N. Y. U. Institute on Federal Taxation, 855, 857, fn. 7.)

D. We do not wish to be understood that the fact that there is an original investment purpose, or at least a purpose other than to sell for the purpose of making a profit, is always controlling. Neither is the use of a broker to dispose of investment property always controlling. But the Tax Court's error was in its failure to analyze the situation to which the particular tests have relevance.

This court and other Courts of Appeals have repeatedly held that the mere fact that an investment is being liquidated is not sufficient to bring Section 117(j) into play. (*Ehrman v. Commissioner,* 120 F. 2d 607 (C. A. 9th); *Commissioner v. Boeing,* 106 F. 2d 305 (C. A. 9th); *Richards v. Commissioner,* 81 F. 2d 369 (C. A. 9th); *Mauldin v. Commissioner,* 195 F. 2d 714 (C. A. 10th); *Palos Verdes Corp. v. United States,* 201 F. 2d 258 (C. A. 9th); *Snell v. Commissioner,* 97 F. 2d 891 (C. A. 5th); *Oliver v. Commissioner,* 138 F. 2d 910 (C. A. 4th); *Brown v. Commissioner,* 143 F. 2d 468 (C. A. 5th).)

But those cases are distinguishable from this case because the taxpayers there did not merely liquidate what had been investment property. They took the investment property and actively turned it into something else. A typical case is one in which land used for farming, or inherited land, which is improved by being subdivided, roads put in, and the like, and then sold directly by the taxpayers or through agents. Those cases present an entirely different problem because the property that the taxpayers held for investment was not the property that was ultimately sold, and Section 117(j) is inapplicable by its terms because the property ultimately sold, although derived from the investment property, was in fact never used in the trade or business.

E. The Tax Court concluded its opinion by stating that in *Galena Oaks Corporation v. Scofield,* 218 F. 2d 217 (C. A. 5th), aff'd 116 Fed. Supp. 333 (D. C. S. D. Tex.), "The facts appear to us to be in all essential respects comparable to the facts in the instant case. * * * In our view the decisions of the courts therein and the reasons expressed therefor offer the strongest support for our conclusion here."

The case is distinguishable from this one on all of the principles which we have urged throughout this brief. The first is the importance of an investment purpose prior to a final decision to sell, and the second is that the liquidation of that investment in itself must not constitute the carrying on of a trade or business. *Galena Oaks* was decided for the government because the facts on both of these controlling points were clearly adverse to the taxpayer. Thus, as the District Court stated (p. 334), "The Government * * * contends that the taxpayer was in the business of constructing houses for sale; that this program was interrupted as to the 102 houses, only by reason of FHA regulations, by reason of which it was obliged to rent for a matter of three to four years; and that shortly after such restrictions were removed, the taxpayer continued in its normal business of selling * * * I find that the Government is right * * *" (Pp. 334-335.)

In contrast we have established here, that taxpayers were never in the business of constructing houses for sale, that government regulations did not require them to rent, and that after the disposition of the duplexes in question taxpayers continued in the rental business and never went into the business of selling.

As for the manner in which the houses were sold, there, unlike here, the taxpayer itself carried on every activity normally associated with the business of selling real estate, using its own employees and not the services of an independent broker. Thus, it was found by the District Court (p. 334) that one of taxpayer's principal employees was placed in charge of sales; extensive advertising taken in local papers; for sale signs placed at strategic locations; and prospective purchasers contacted

through taxpayer's Houston office. In short, on the basis of both of the points that control in the decision of this case, the facts in *Galena Oaks* were almost the opposite of those here. Accordingly, when the Tax Court states, as it did, that the case offers the "strongest support for our conclusion here" it has shown both the enormity of its misconception of the law applicable to this case, and the utter dearth of authority for its position.

F. There remains to consider as a group the cases decided by this court on the applicability of Section 117(j) to the sale of real estate. An analysis of those cases holding Section 117(j) inapplicable establishes not only that they are clearly distinguishable from the facts of this case, but, in addition, the court's analysis of the problem lends additional support for the reversal of the Tax Court here.

McGah v. Commissioner, supra, was a reversal of the Tax Court and held Section 117(j) applicable to the sale of war housing. Although we think the decision of this court was fully justified on the facts, we submit that the investment purpose shown in this case, and the complete passivity of the taxpayers, make this case an *a fortiori* one for reaching the result that the court reached in *McGah.*

Rollingwood v. Commissioner, supra, has already been discussed. That case correctly analyzed the purpose of Section 117(j) and properly denied its application because it was clear that taxpayers had always intended to sell. *Cohn v. Commissioner, supra,* likewise was a case where the purpose of acquisition was sale.

In *Homann v. Commissioner,* 230 F. 2d 671, the taxpayer had no investment purpose whatever once the houses were built. They were rented on a month-to-month basis

under an agreement whereby rentals could be applied to purchase prices and taxpayer's agent *always* had authority to sell. To the same effect was *Rubino v. Commissioner,* 186 F. 2d 304, affirming *per curiam Rubino v. Commissioner,* 1949 P-H Memo T. C. 48,288.

In *Shearer v. Smyth,* 221 F. 2d 478 (affirming, *per curiam,* the District Court's decision in 116 Fed. Supp. 230); *Palos Verdes Corp. v. United States, supra; Ehrman v. Commissioner, supra; Commissioner v. Boeing, supra,* and *Richards v. Commissioner, supra,* although the property was not (or may not have been) originally held for sale, the liquidation of the property itself constituted a trade or business, for the reasons that: (1) substantial activity or investment was made in readying the property for sale (such as subdividing and improving), or (2) the sales were made by taxpayer or his employees, not an independent contractor, and were made over a period of years.

The presence of either of these circumstances as we have emphasized has often been treated as indicative of a new business carried on by a taxpayer, despite the fact that an investment is being liquidated. Conversely, where as here taxpayers did not change the form of their investment property in order to sell,[32] and the sale activities were carried on by others, we have a clear case for the application of Section 117(j).

The fact then that a number of cases have been decided by this Circuit against the application of Section 117(j) is, we submit, not indicative of a disagreement with such circuits as the Third, Fourth, Fifth, Seventh, Eighth and

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[32]All of the property was sold strictly as it was when rented. The duplexes were not even repainted. [R. 379.]

Tenth, which have decided cases which require the reversal of the Tax Court here. It is indicative only of the fact that with the exception of *McGah* this is the first case to come before this court which requires the application of Section 117(j) on the basis of standards heretofore so well expressed by this court in such cases as *Rollingwood* and *McGah,* and the Third, Fourth, Fifth, Seventh, Eighth and Tenth Circuits in the cases cited *supra.*

Conclusion.

The decision of the Tax Court is erroneous and should be reversed.

Respectfully submitted,

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April, 1957.

Of Counsel:

MITCHELL, SILBERBERG & KNUPP.